Absorption vs Marginal Costing

Accounting & Finance

Two ways to cost a product, and why profit differs between them.

Absorption costing

- Fixed overhead included in unit cost
- Required for external reporting
- Profit rises when inventory rises
- Needs an overhead absorption rate
- Can encourage overproduction

Marginal costing

- Only variable costs in unit cost
- Fixed costs charged to the period
- Profit tracks sales, not production
- Simpler and clearer for decisions
- Not permitted for statutory accounts

THE DIFFERENCE THAT MATTERS

When production exceeds sales, absorption reports higher profit — fixed overhead is carried forward in stock.

The difference in profit equals the change in inventory units times the fixed overhead per unit. Always.